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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 943

HOWARD DAVIS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioner, Howard Davis, by his undersigned attorneys, respectfully prays for a writ of certiorari to The United States Court of Appeals for the Seventh Circuit in the foregoing cause.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit was rendered on December 13, 1956, and is reported in 239 F. 2d 187 (R. 266-271).

The opinion and findings of fact of The Tax Court of the United States were promulgated on April 14, 1955, and are reported in 55,087 Prentice-Hall Memo. T.C. (R. 247-257). The decision of The Tax Court of the United States was entered on May 25, 1955 (R. 262).

JURISDICTION

The Judgment of the Seventh Circuit sought to be reviewed was entered on December 13, 1956 (R. 239); and the time for filing this petition was extended to April 27th, 1957, by order of Mr. Justice Harold H. Burton on March 13, 1957.

Jurisdiction is conferred upon the Supreme Court of the United States to review this cause by writ of certiorari by Section 1254 (Title 28, U.S.C.A.) as enacted June 25, 1948; and the petition is timely within the purview of Section 2101 (c) of the Judicial Code (Title 28, U.S.C.A.).

QUESTIONS PRESENTED

1. Where a taxpayer, who has been a farmer for many years, supplements his farming operations with the manufacture of a product from agricultural material, and keeps separate records of the farm operations and the manufacturing operations, was the Court below correct in approving the net worth method of determining taxable net income which included farm inventories in the computation; or

Did the inclusion of farm inventories in the computation deprive such farmer of his statutory privilege not to inventory unsold farm crops?

2. Is is correct to apply the net worth method of determining taxable net income to a farmer-manufac-

turer, where the only evidence of unreported income is a stipulated omission of part of the farm income, apparently more than offset by a stipulated omission of farm purchases and expenses and the record shows no evidence of inadequacy, incompleteness, or inaccuracy of the manufacturing records?

3. Is it correct to apply the net worth method at all under the conditions set forth in the foregoing questions, where the manufacturing records were available at audit and trial, and showed no evidence of wrongdoing, and where the farm records were made available to the Government at the inception of the audit, but were subsequently destroyed by fire through no fault of the taxpayer, and the amount of farm income and expense was stipulated?

4. Where the Tax Court finds the opening net worth to have been erroneous, as a result of the inclusion therein of salable merchandise shown on a financial statement rendered more than six months prior to the opening net worth date; is the error rectified by substituting salable merchandise shown on a financial statement rendered three months after the opening net worth date?

Or should the Court below have held that as a consequence of the Commissioner's failure to establish opening salable inventories, the Commissioner of Internal Revenue had failed to establish a sound opening net worth, that his statutory deficiency notice lacked probative value, and that the existence of a deficiency had not been established?

5. Where the Tax Court finds the opening net worth at December 31, 1941, contained in the deficiency

notice (R. 8, 13, 19, 24) to be substantially incorrect;[1] and by self-evident fallacious reasoning affirms the amount of cash determined by the respondent[2] was the Court below correct in affirming the Tax Court's findings;

Or should it have held that the net worth evidence was whimsical and determined there was no deficiency?

6. Was it error for the Court to fail to provide for the taxpayer's liability to his mother, in view of the following stipulation (R. 179):

> "It is further stipulated and agreed that the parties to this proceeding don't know to whom the income or the expenses belong as between the Petitioner and his mother. And Respondent of course maintains its position that we are on the net worth method and is not stipulating as to any other method of determining income."

Or, does the failure to so provide destroy the probative value of the net worth computation?

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[1] The deficiency notice is based on an inventory of $9,221.46 at December 31, 1941 (R. 8, 13, 19, 24) whereas the Tax Court determines an inventory on that date of $31,352.00 (R. 249, 253) which is the same amount the petitioner shows on his financial statement three months later (R. 197, Res. Exh. C).

[2] The deficiency notice is based on cash of $933.00 at December 31, 1941 (R. 8, 13, 19, 24) which is the same as the taxpayer shows on his financial statement six months earlier (R. 195, Exh. B) in two amounts, that is $548.00 and $385.00. However, between the dates of June 12, 1941 (R. 195, Res. Exh. B) and April 1, 1942 (R. 195, Res. Exh. B) the debts of the taxpayer increased only $9500.00, from $1500.00 (R. 195, Res. Exh. B) to $11,000.00 (R. 197, Res. Exh. C): how then could the taxpayer increase his inventory to $22,130.56 from cash of $933.00 and no taxable income for the year 1941? Obviously, he had a large amount of cash not shown in his financial statement.

7. Where a taxpayer, engaged both in farming and manufacturing, made his tax returns upon the cash basis of accounting, may the Commissioner of Internal Revenue and the Tax Court, in determining his net worth, include therein items which are properly included only upon an accrual basis of accounting, such as inventories and accounts receivable?

Or should the Court below have adjusted the returns upon the accrual basis of accounting for the manufacturing business?

8. Where the Commissioner of Internal Revenue has determined the opening and closing net worth of the taxpayer by listing his assets and liabilities at the beginning and close of a four year period, was the Court below correct in accepting alleged resulting deficiencies determined by allocating to each year such proportion of the total increase in net worth as each year's sales bore to the total sales?

Or should the Court below have held that the alleged deficiency had not been adequately established, as a consequence of the failure of the Commissioner to compute net worth at the close of each year?

9. May a penalty of 25% be assessed for "willful neglect" to file a return, under Section 291 (a) of the Internal Revenue Code of 1939, where the return in question was signed only by the accountant for the taxpayer, and thereupon filed, and there is no evidence that the failure of the taxpayer to sign the return was caused by anything other than inadvertence?

10. May a penalty of 50% be assessed for fraud, under Section 293(b) of the Internal Revenue Code of 1939, where the tax return in question was signed

only by the accountant for the taxpayer, and the Tax Court held it to be "no return"?

11. Has the Commissioner of Internal Revenue sustained the burden of proof required to impose the 50% fraud penalty under Section 293(b) of the Internal Revenue Code of 1939, where he failed to establish any omissions in the taxpayer's books and records, where he failed to adduce any evidence of specific intent to defraud, and where the net worth method, utilized by him to establish the alleged deficiency, contained the following faults:

(a) Cash and inventory for opening net worth are not supported by the evidence, being in fact specious.

(b) A net worth computation for the entire period from December 31, 1941, to December 31, 1945, arrived at without findings of net worth at the close of each of the intervening years;

(c) A determination of net worth for the intervening dates of December 31, 1942, 1943, and 1944, by allocating to each year such part of the overall increase in net worth as each year's sales bear to the total sales for the four years;

(d) Including in the net worth computation inventories and accounts receivable for both the taxpayer's farm operation and for his manufacturing business, despite the fact that inventories are not required of farmers, and that accounts receivable are not included in the cash basis of accounting, the basis used by the taxpayer?

12. (a) Where the Commissioner of Internal Revenue issues a statutory deficiency notice predicated upon a net worth computation, and the proof shows

each alleged deficiency to be whimsical and grossly erroneous, does not the deficiency notice lose its presumption of correctness?

(b) And if no presumption of correctness attaches to the deficiency notice, and the Commissioner fails to adduce independent evidence at the trial to establish any deficiencies, should not the Court below have held that the Commissioner had failed to sustain the burden of establishing a deficiency?

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 as amended (Title 26, U.S.C. 1939) are Sections 41, 291 (a), 293 (b), 1112, and Treasury Regulations 111, Section 29.22 (a)-7 and are set forth in the Appendix herein.

STATEMENT OF THE CASE

Petitioner was born in 1903, and has always resided in Madison County, Indiana. He has been a farmer since his graduation from high school. His subsequent education was limited to a six weeks extension course in dairy production. He had no knowledge of bookkeeping.

In 1932 Petitioner commenced raising popcorn on the family farm, together with his other crops, and in 1935, he began contracting with other farmers to raise and sell popcorn to him. In 1939 he started a small plant to manufacture popcorn, which he later expanded.

In 1941, Petitioner acquired an especially large quantity of popcorn to supply the Overland Candy Company, which did not take the popcorn. At the end

of 1941, Petitioner had approximately 1,800,000 pounds stored in cribs on the family farm at a cost of at least $30,000. Petitioner had additional popcorn stored at his manufacturing plant and on farms of others. Petitioner testified several times, and the evidence is not refuted, that in addition to approximately 600,000 pounds raised on the family farm during 1941, he had firm contracts with other farmers covering approximately 2,000 acres, which would yield 3,000,000 to 4,000,000 pounds, and additional acreage on open or market price contracts. (R. 43, 51, 73). The taxpayer honored these contracts and purchased the corn in 1941 (R. 52). At the average price received by growers in 1941, this firm purchased popcorn cost between $60,000 and $80,000. Yet the Tax Court found that the cost of all popcorn owned by Petitioner at January 1, 1942, was approximately $31,352, which figure was taken from a financial statement dated April 1942, without reference to any prior sales in 1942.

The Tax Court found that Petitioner's cash at January 1, 1942, was only $993. On the other hand, Petitioner testified and the evidence was not refuted, that he had approximately $150,000 in cash at that time. (R. 103, 126-128)

During the period in question, 1942 to 1945, Petitioner was a grower (including gathering, shucking and storing), processor (shelling, cleaning and bagging), and manufacturer of popcorn. Records of the growing and processing operations, and purchases, were kept personally by Petitioner. These records, consisting of a day book which listed all amounts received and paid out, were destroyed by fire in 1946, (R. 55, 57) one year subsequent to the start of an investigation by the Treasury Department. Petitioner

testified that all of these records had been made available to Internal Revenue Agent James Van Winkle and that during the first year of investigation Treasury Agents were frequently in and out of the office where these records were kept, but never then looked at the books. (R. 56) Mr. Van Winkle was present at the hearing and testified on other matters, but was not asked to, and did not, refute this evidence.

The records of the popping operation were maintained by the plant manager until the middle of 1944, and thereafter by a bookkeeper in accordance with instructions of Petitioner's accountant. An independent certified public accountant and former Treasury Department employee, Scott Hosier, testified that he had made an examination of these records, and that they were sufficiently complete to permit an audit and determination of the net income of the operation. (R. 176-177)

Petitioner filed financial statements, certified by him, with the Anderson Banking Company showing net worth as follows: June 12, 1941—$64,466.49, April 1, 1942—$74,093.00, January 3, 1944—$112,549.00, January 3, 1945—$126,602.78, and November 10, 1945—$430,634.92, and these statements were the basis of the Respondent's determination of increase in net worth and taxable income. Petitioner admitted the correctness of the last statement, which had been prepared by his accountant. Petitioner testified that the other statements were prepared by him from memory and not from his books, that they were submitted solely to substantiate the credit he was seeking at the time, and that the assets were grossly understated (R. 62, 101-102). On January 9, 1945, which was some time before the income tax investigation began, the

Petitioner wrote the bank that in his June 11, 1941, statement his net worth was substantially understated because he thought the assets shown were adequate for credit purposes and therefore only made a partial statement of assets (R. 186, Pet. Exh. No. 1).

Petitioner's Income Tax return for 1942 was prepared by Grace de Armond, a practicing lawyer of Anderson, and the returns for 1943, 1944, and 1945 were prepared by Charles Scott, a public accountant of Anderson. (R. 46, 145-146, 150-151)

Petitioner in the years under review paid income tax aggregating $16,131.55. The Respondent determined that Petitioner's net worth had increased during the four years in question, in the amount of $241,080.74, basing his opening net worth solely on the financial statement filed by the petitioner with the Anderson Banking Company on June 12, 1941, as adjusted by the Respondent. The Tax Court found a net worth increase of $230,357.94 during that period, making certain adjustments for the cost of salable merchandise on hand at the beginning of the period, and on the basis of this finding, together with the admitted income tax payments and living expenses, found that Petitioner's total income for the four years was $280,489.49. The income thus determined was allocated both by Respondent and by the Tax Court over the four year period, on the basis of the percentage of adjusted gross sales in each year to the total adjusted gross sales for the four year period.

The Tax Court also found that at least part of the resulting deficiency in each of the years in question was due to fraud with intent to evade tax.

ARGUMENT AND REASONS FOR GRANTING THE WRIT

Introduction

At the outset let us state that this petition and the questions presented is indubitably due to the fact that this case originated and was tried long before this Court decided *Holland* v. *U. S.* (348 U.S. 121) and the companion cases of *Friedberg* v. *U. S.* (348 U.S. 142), *Smith* v. *U. S.* (348 U.S. 147) and *U. S.* v. *Calderson* (348 U.S. 160) wherein the rules of law on the determination of net income by the net worth method were expounded. The Court below failed to apply the rules of law set down for its guidance in the above cases.

The above four cases were decided by this Court on December 6, 1954; whereas the statutory deficiency notice here is dated September 21, 1948 (R. 5), the trial before the Tax Court of the United States began on October 21, 1953 (R. 32), and that Court's opinion is dated April 14, 1955 (R. 247), just four months after this Court spoke in the above cases. The decision of the Court below, however, was rendered on December 13, 1956, two years after this Court spoke (R. 267).

The questions presented are numerous, but are necessary in order to raise the errors, some of which, perhaps, would not have arisen had the case been decided on the rationale of *Holland* v. *U. S.* (348 U.S. 121) and companion cases.

In our opinion, the writ should issue, because it submits an issue that has not been, but should be settled by this Court, that is, the application of the net worth method to and its mode of application to a farmer taxpayer; and whether resort to the net worth method should be had in the case at bar; also because

the decision here is in conflict with applicable decisions of this Court.

Farmer

The position of the farmer in our system of taxation has always been a favored one. He need not—unless he elects to do so—maintain inventories of unsold crops, and he need not keep records to the same degree as other taxpayers do.

We fully realize that a farmer should not be, and is not, immune from the use of the net worth method. Nevertheless, the net worth method when applied to him should be applied in a manner consistent with the principles of taxation that apply to farmers. Such a net worth method should not include inventories. To include inventories of farm products unsold in a net worth computation subjects the farmer to taxation to which he is not subject; and makes the proof of fraud based thereon self-operating so that he becomes guilty of fraud where in fact there is no fraud.

Here, the omitted farm income and purchases and expense have been stipulated (R. 178-180). Indeed it appears that the stipulation establishes the opposite of fraud—purchases and expenses appear to exceed omission of sales (R. 179)—and the respondent frankly stipulates he does not know to whom such omitted income belongs (R. 179).

Here the farm records were available when the Commissioner started his investigation. They were offered to him. Time passed while the Commissioner investigated other activities of the taxpayer. The farm records were destroyed in a grain elevator fire (R. 55) and the taxpayer was injured in an effort to save them (R. 55). Nevertheless, the Commis-

sioner, in some manner, established figures for farm income and expense that he was prepared to, and did, stipulate (R. 178-180).

We submit that, under the circumstances, there were no grounds for the use of the net worth method to the farm operations.

Farmer-Manufacturer

Here, the farmer, after converting his crop-lands to the growing of corn suitable for popping in 1932 (R. 36), engaged in the popcorn manufacturing business in 1939 (R. 41), conducting such business as a sole proprietor and reporting on a cash basis. Separate records were maintained for the manufacturing business; and no proof was adduced of their inaccuracy or incompleteness. In fact, the respondent in his statutory deficiency notice made no correction respecting manufacturing income (R. 7, 12, 18, 23, 179, 251). The only corrections made related to omitted farm sales (R. 7, 12, 18, 23, 179, 251). The petitioner, on the other hand, adduced testimony of the computation of income from the books of the manufacturing business (R. 188-193, Pet. Exh. 10, 12, 13, 14).

The return of the manufacturing business as well as the farm business was made on a cash basis (R. 248). The net worth method computation, nevertheless, includes accounts receivables and inventories (R. 8, 13, 19, 24).

The inclusion of unrealized accounts receivable in a net worth statement of a cash basis taxpayer distorts the net worth result to an extent that the net worth is no criteria for a correct determination of income. The result so obtained creates income that in fact is not realized during the net worth period.

There was no occasion to disregard the manufacturing books and records and no evidence other than the net worth computation was adduced to establish the inaccuracy of the books. Therefore, the manufacturing business did not serve as a ground for the use of the net worth method.

We submit, that under the circumstances there was no premise for the application of the net worth method to the manufacturing business. If the net worth method is applicable here to the farming operations or the manufacturing operations—but not to both—there is no occasion to invoke such method for both operations. The results obtained by the application of such method to both operations distorts income instead of establishing a correct taxable income.

Opening Net Worth

The gross inadequacy of the opening net worth found by the Tax Court is manifest from the undisputed testimony of the taxpayer that in 1941 he entered into firm contracts with farmers to take the popcorn produced on about 2,000 acres, expecting to sell it to the Overland Candy Company (R. 51); that this was in addition to popcorn raised and purchased to meet his own requirements (R. 51); that he kept the popcorn throughout 1941 and 1942, because of uncertainty as to whether he would have to deliver it to the Overland Candy Company (R. 52); that in 1941 a good farmer would average from 1,500 to 2,000 pounds per acre (R. 43); that the price of corn during 1941 was between four and five cents a pound (R. 52). There is no evidence whatsoever to support the Tax Court's finding of an average price of 2.08 per hundred pounds (R. 253). If we average these uncon-

troverted figures, and assume an average product of 1,750 pounds per acre, and an average price of 4½ cents per pound, the cost of the inventory held by the taxpayer from the contracted 2,000 acres alone was $157,500. When this figure is contrasted with the opening inventory of $31,352, upon which the alleged deficiency is predicated, the fantastic understatement compels the conclusion that the affirmance of the judgment of the Tax Court by the Court of Appeals was manifest error, and should be reversed by this Court.

Annual Net Worth

Here the annual net worth was determined by allotting to each year such part of the overall four year increase as each year's sales bore to the total sales of the four years.

We submit that this is in conflict with the holding of this Court in *Holland* v. *U. S.* (348 U.S. 121). The use of such a theory is contrary to the principles involved in the net worth method. Net worth means assets less liabilities at the beginning and end of each year because taxation is based on an annual accounting period; and, there is no reason why the determination should not have been made in that manner.

The margin of profit on sales is not sufficiently stable to warrant using sales as a basis of allocation. Assuming arguendo, that allocation of income to sales is proper in certain stable businesses—here the evidence shows the contrary. The respondent and the Tax Court allocated 48.89% or $146,337.31 of the increased net worth to the year 1945 (R. 7, 12, 18, 23, 179, 251). Yet this is the year that unreported farm sales were only $928.87 (R. 7, 12, 18, 23, 179, 251) and the year in

which the taxpayer-manufacturer was subjected to heavy seizures of shipments by the Pure Food Administration (R. 120-121). The loss of product in 1945 was about $40,000 plus freight (R. 121) and litigation expenses (R. 122). Obviously, under such circumstances there was no constant rate of profit.

We submit that a net worth method that does not result in annual rests of net worth is a nullity.

No Return for 1944

For the year 1944 the taxpayer filed a return that was unsigned. The taxpayer did not sign it, nor did anyone else on his behalf. The only signature on the return was that of the accountant who prepared the return, and he signed it only in the space provided for the person preparing the return. The Tax Court, quite properly, held such a return to be no return at all (R. 248, 256).

We submit that filing an unsigned return and paying the tax is not "willful neglect"—within the meaning of Section 291—obviously such failure to sign is an inadvertence. Therefore, there is no premise on which to assert a negligence penalty.

We further submit that there is no provision of law whatsoever for the assertion of a 50% fraud penalty for the failure to file a return.

Fraud

The burden of proof in establishing fraud is upon the respondent. Fraud is not to be presumed but must be established by clear and convincing evidence. There is not a scintilla of evidence here to establish fraud. What is the record?

At trial the respondent offered no evidence whatsoever to affirmatively establish fraud. The deficiency notice premised on the net worth theory violates every concept of farm accounting and a cash basis of accounting for the manufacturing business. Assuming arguendo that farm inventories and accruals in the manufacturing business are proper items of a net worth method of determining taxable income—that does not establish fraud. It establishes nothing more than that the wrong methods of accounting were employed in preparing the returns.

The only evidence offered by the respondent at trial was one witness, James Van Winkle (R. 91-98) whose entire testimony was confined to one schedule, Respondent's Exh. O (R. 239-241) which was a series of transactions for the year 1943 between the taxpayer as a farmer on the one hand with the taxpayer as a manufacturer on the other hand.

We submit that a transaction on which the taxpayer is on both sides cannot create income for the taxpayer—certainly it is not evidence establishing fraud for the year 1943 nor for the other three years.

The only other evidence adduced by the respondent appearing in the record is a series of nine Exhibits (R. 195-211, 239-243) that do not establish fraud. We have omitted Res. Exh. M (R. 212-238) from the preceding statement for a special reason, that is, the document appears in the record in its complete form. However, only part of it was received in evidence, that is the introductory part, to establish when and where it was done (R. 98) and the particular question 84 (R. 82). Question 84 (R. 222) is no proof of fraud.

The Tax Court in its finding of fact (R. 248-252) makes no findings respecting fraud, excepting the ultimate finding (R. 252) which reads:

> "At least part of the resulting deficiency in each of the above years (1942, 1943, 1944, 1945) was due to fraud with intent to evade tax."

We submit that the imposition of a civil fraud penalty of 50% on such flimsy evidence does not meet the test of clear and convincing evidence, particularly where the net worth presentation departs from proper concepts of taxable net income.

CONCLUSION

We submit that the net worth method had no application to the case at bar; that if it did, the principles of accounting allowed a farmer should have been taken into account and the manufacturing items treated on a cash basis; that the net worth as prepared is in conflict with the decisions of this Court in *Holland* v. *U. S.* (348 U.S. 121) and companion cases (348 U.S. 142, 147, 160) inter alia, the failure to establish a net worth for each of the intervening years, December 31, 1942, 1943, and 1944; and, the Tax Court and the Court below have so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

WHEREFORE, your petitioner prays that a writ of certiorari issue to the United States Court of Appeals for the Seventh Circuit, commanding that Court to certify and send to this Court on a day to be determined a full and complete transcript of the record of all the proceedings of such Court of Appeals had in this cause, to the end that the proceedings and decisions

therein may be reviewed and determined by this Court; that the judgment of the Court of Appeals be reversed; and that the petitioner be granted such other and further relief as may seem proper.

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APPENDIX

Internal Revenue Code of 1939 (Title 26, U.S.C. 1939):

Section 41. GENERAL RULE:

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Section 291. FAILURE TO FILE RETURN:

(a) In case of any failure to make and file return required by this chapter, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this sec-

tion shall be in lieu of the 25 per centum addition to the tax provided in section 3612 (d) (1).

Section 293. FRAUD:

(b) If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612 (d) (1).

CHAPTER 5—THE TAX COURT OF THE UNITED STATES

SUBCHAPTER A—ORGANIZATION, JURISDICTION AND PROCEDURE

Section 1112. BURDEN OF PROOF IN FRAUD CASES.

In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Commissioner.

Treasury Regulations 111

SECTION 29.22 (a)-7

A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which

were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income. * * *.

OPINION

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 11606 SEPTEMBER TERM AND SESSION, 1956

HOWARD DAVIS, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of a Decision of the Tax Court of the United States.

December 13, 1956

Before FINNEGAN, SWAIM and SCHNACKENBERG, *Circuit Judges.*

SWAIM, *Circuit Judge.* Petitioner-taxpayer seeks review of a decision of the Tax Court of the United States, 14

T.C.M. 294, which determined that there were deficiencies in his income tax for the years 1942 through 1945, inclusive, and found that at least part of the deficiency in each year was due to fraud with intent to evade tax. In determining that the taxpayer had understated his taxable income for the years in question, the Commissioner utilized the net worth method.

Taxpayer complains that the Commissioner was not warranted in resorting to the net worth method of proving taxable income under the circumstances in this case; that certain net worth computations were clearly erroneous; and that the Tax Court erred in holding that the Commissioner had sustained the burden of proving fraud.

As to the first question, it is taxpayer's contention that the net worth method may be used notwithstanding the presence of records only where evidence of concealment or falsity exists. The Supreme Court has expressly held, however, that the net worth method is not confined to situations where the taxpayer has no books or where his books are inadequate. *Holland* v. *United States*, 348 U. S. 120, 130-132. Taxpayer's argument is the same argument rejected by the Court in the *Holland* case for concealment and falsity necessarily impugn the adequacy of a taxpayer's books. Although the *Holland* case was a criminal case, there is no reason why the analysis therein should not apply with equal force to a civil case or why the use of the net worth method should be more circumscribed in the case of a deficiency determination. See *Thomas* v. *Commissioner of Internal Revenue*, 6 Cir., 223 F. 2d 83, 86.

Taxpayer obviously overlooks the fact that the net worth technique of computing income is not a method of accounting. It is no more than proof of income by circumstantial or indirect evidence. If a taxpayer's net worth has increased over a period of time and the increase is not due to nontaxable receipts or nontaxable appreciation of assets, the conclusion is inescapable that taxable income

has been received. The fact that the taxpayer's books and other records are consistent with his income tax returns or are internally consistent proves nothing more than that they are consistent; it does not establish that they are truthful or accurate. See *Holland* v. *United States,* 348 U. S. at pp. 131-132. In short, the apparent adequacy of the taxpayer's books is the very thing that the net worth method attacks by independently demonstrating the receipt of unrecorded and unreported taxable income. The *Holland* decision makes it clear that there are no conditions precedent to the utilization of the net worth technique. The Court stated, 348 U. S. at pp. 131-132:

> "Petitioners' accounting system was appropriate for their business purposes; and, admittedly, the Government did not detect any specific false entries therein. Nevertheless, if we believe the Government's evidence, as the jury did, we must conclude that the defendants' books were more consistent than truthful, and that many items of income had disappeared before they had even reached the recording stage. *Certainly Congress never intended to make § 41 a set of blinders which prevents the Government from looking beyond the self-serving declarations in a taxpayer's books. * * * To protect the revenue from those who do not 'render true accounts,' the Government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history.*" (Emphasis added.)

See also *Canton* v. *United States,* 8 Cir., 226 F. 2d 313, 322-323.

Furthermore, the Tax Court found that taxpayer's records were not adequate and this finding is well supported by the evidence. Taxpayer was engaged in the business of growing, buying, processing and selling popcorn. Records of purchases of popcorn and all records in connection with his farm and the processing of popcorn were maintained personally by taxpayer prior to and during the tax-

able years. These records, consisting of a day book kept on a cash basis, were destroyed by fire subsequent to the start of an investigation of his income tax returns. From 1940 until the middle of 1944, records of taxpayer's popping operations were maintained by his plant manager. Thereafter, these records were maintained by another employee in accordance with instructions from taxpayer's accountant. The record indicates, and the Tax Court so found, that taxpayer did not keep an accurate record of inventory and purchases which were undoubtedly important in determining his net income. And the parties had stipulated that there was unreported income, in substantial amounts, from the farm owned by petitioner and his mother in the years 1942, 1943 and 1944. This fact alone contradicts taxpayer's contention that his farm records were accurately maintained. The taxpayer himself admitted the inadequacy of his books and records in a letter written to a bank stating that "Until January 1945 I did not have an adequate set of books for the volume of business I was doing." Taxpayer's attempt to explain away this admission is not convincing.

No useful purpose would be served by repeating the history and ramifications of taxpayer's business activities and we shall limit ourselves to such detail as is necessary to the particular questions raised. Apart from the propriety of using the net worth method, taxpayer attacks the accuracy of the Commissioner's determination of opening net worth on January 1, 1942, in two particulars: cash on hand and popcorn inventory.

CASH ON HAND. The Commissioner determined that taxpayer had $933.00 in cash on January 1, 1942. This amount was taken from a financial statement, certified by taxpayer, that was submitted by him to a bank to obtain a loan. Taxpayer's contention that he had additional cash is refuted by his testimony that he used all of his cash and the money he could borrow to buy substan-

tial quantities of popcorn during the latter part of 1941. On cross-examination, taxpayer was repeatedly asked to state any assets which he owned that were not listed on the financial statement and he could not recall any. After a luncheon recess taxpayer "remembered" that he had a cash hoard of $150,000.00 which had been hidden on his farm since 1936. Taxpayer's financial history negates the existence of such a cache. Between January 1, 1935 and December 3, 1941, taxpayer has a record of continuous borrowings from the Pendleton Banking Company. As to the question of a likely source for the cash, which taxpayer did not attempt to explain, the record shows that he did not file an income tax return prior to the year 1942 when he filed a nontaxable return for 1941. In addition, there is no record that his parents ever filed an income tax return and his father, who died on February 14, 1934, left personal property appraised at only $10,653.03.

We think the Tax Court was generous in fixing $933.00 as the amount of cash on hand at the beginning of the net worth period. Taxpayer's financial statements, considering other evidence in the case, furnished a substantial basis for the court's finding on this question, see *Bodoglau* v. *Commissioner of Internal Revenue*, 7 Cir., 230 F. 2d 336, 340, and we cannot say that the finding was clearly erroneous.

INVENTORY. Taxpayer's income tax return for the year 1942 reported an opening inventory on January 1, 1942, of $9,221.46. This amount was used by the Commissioner in computing taxpayer's initial net worth. The Tax Court, however, found that the inventory was $31,352.00, the amount certified by taxpayer to be his inventory in April 1942, in a financial statement submitted to a bank. Taxpayer insists that certain purchase contracts for popcorn which would have increased his inventory were not taken into account. The Tax Court's finding of fact cannot be set aside unless clearly erroneous and due regard

must be given to the opportunity of the court to judge the credibility of the witnesses. The taxpayer's admissions clearly contradict the amounts contended for by him and the evidence refuted the existence of an inventory in excess of the amount found. The Tax Court was justified in rejecting taxpayer's "wholly unsupported testimony" and we cannot say that its finding in this regard is clearly erroneous.

Taxpayer argues that there was no showing of a likely source to explain the increase in net worth. There was ample evidence that substantial amounts of income had not been included in taxpayer's books and records. It was shown that taxpayer was engaged in a profitable business of considerable dimensions; that the business was capable of producing much more income than was reported and was sufficient to account for the increase in net worth; that taxpayer could not have received any large inheritances or gifts from his parents; and it was stipulated that he received income in excess of the amounts reported on his tax returns. Statements given to banks by taxpayer established an even larger increase in net worth than the amount determined by the Tax Court. Taxpayer's only evidence in this regard purports to show that because of governmental price regulations his business could not have produced such income as is shown by the net worth computations. The testimony as to profit percentages, upon which taxpayer relies, applied only to the profit of a popcorn processor. However, processing was only one aspect of taxpayer's business; his activities encompassed growing, buying, processing and popping of corn. Further, even when the profit percentages contended for by petitioner are used, his income was still far greater than that shown on his tax returns.

Finally, taxpayer contends that the Tax Court erred in finding that a part of the deficiency for each of the taxable years was due to fraud with intent to evade tax.

The question whether taxpayer filed returns with intent to evade tax is a question of fact and the burden of proof is upon the Commissioner. *Kurnick* v. *Commissioner of Internal Revenue*, 6 Cir., 232 F. 2d 678; *Bodoglau* v. *Commissioner of Internal Revenue*, 7 Cir., 230 F. 2d 336. The Tax Court's finding on the issue of fraud is entitled to finality unless clearly erroneous. *Bodoglau* v. *Commissioner of Internal Revenue, supra.* Taxpayer reported income of $57,856.88 during the years in question when his actual income during this period was $280,489.49. Understatement of income alone is not proof of fraud, *Wiseley* v. *Commissioner of Internal Revenue*, 6 Cir., 185 F. 2d 263, but consistent, substantial understatement of income is highly persuasive evidence of intent to defraud. See *Holland* v. *United States*, 348 U. S. 121, 139; *Kurnick* v. *Commissioner of Internal Revenue*, 6 Cir., 232 F. 2d 678, 681; *Bodoglau* v. *Commissioner of Internal Revenue*, 7 Cir., 230 F. 2d 336, 341.

Taxpayer's financial statements made over a period of years indicate that he knew his net worth was increasing and that his tax returns did not correctly record this increase. More specifically, a letter written to taxpayer by his accountant stated that for the period from January 1, 1945 to October 31, 1945, taxpayer's income from his business was $59,745.56 on a cash basis and $116,906.50 on an accrual basis, yet he reported income for the year of only $26,594.96. The record also shows that there was little relation between taxpayer's personal expenditures and his reported income; that in at least two of the taxable years he was spending money in excess of the amounts reported by him. In addition, taxpayer admittedly failed to report substantial amounts of income from his farm. Fraud may not be lightly inferred, *Rogers* v. *Commissioner of Internal Revenue*, 6 Cir., 111 F. 2d 987, but the evidence in this case is clear and convincing. We hold that the Tax Court's finding in this regard has sub-

stantial support in the record and should not be disturbed by this court.

The decision of the Tax Court is AFFIRMED.

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Thursday, December 13, 1956

Before

Hon. PHILIP J. FINNEGAN, Circuit Judge, Hon. H. NATHAN SWAIM, Circuit Judge, Hon. ELMER J. SCHNACKENBERG, Circuit Judge

No. 11606

HOWARD DAVIS, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Petition for Review of a Decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on May 25, 1955, be, and the same is hereby, AFFIRMED

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 943

HOWARD DAVIS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 247-257) are not officially reported. The opinion of the Court of Appeals (App. 3a-10a)[1] is reported at 239 F. 2d 187.

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[1] Appendix references are to the Appendix to the petition for certiorari.

JURISDICTION

The judgment of the Court of Appeals affirming the Tax Court's decision was entered on December 13, 1956. (App. 10a.) On March 13, 1957, the time for filing a petition for certiorari was extended until April 27, 1957. The petition for a writ of certiorari was filed on April 26, 1957. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the Tax Court and the Court of Appeals correctly determined the taxpayer's net income by use of the net worth method.

2. Whether the Tax Court and the Court of Appeals correctly found that a part of the deficiency for each of the taxable years was due to fraud with intent to evade tax.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.
>
> * * * * *
>
> (b) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2).
>
> (26 U.S.C., 1952 ed., Sec. 293.)

STATEMENT

Taxpayer was engaged in the business of growing, buying, processing and selling popcorn. (R. 249.) Adjusted gross income from such business, for the years 1942 through 1945, was reported in the following amounts (R. 252):

1942	$ 4,978.14
1943	8,604.22
1944	17,679.56
1945	26,594.96
(Total	$57,856.88)

Asserting income tax deficiencies and fraud and delinquency penalties, the Commissioner computed taxpayer's income by the net worth method. This computation disclosed taxable income for the entire period in the amount of $302,412.29, which, on the basis of annual sales, was allocated to the four taxable years as follows (R. 7):

1942	$ 20,715.24
1943	59,091.36
1944	76,268.38
1945	146,337.31

A petition for redetermination having been filed in the Tax Court, taxpayer challenged the propriety of using the net worth method of computing income, the computation of his opening net worth, and the assertion of the fraud and delinquency penalties. (R. 252-253, 255-256.)

The facts found by the Tax Court with respect to these issues may be summarized as follows:

Records of purchases of popcorn and all records in connection with the farm and the processing of pop-

corn were maintained personally by taxpayer prior to and during the taxable years. These records, which consisted of a day book in which taxpayer recorded amounts paid out and received, were destroyed by fire in 1946 subsequent to the start of an investigation of taxpayer's income tax returns. No attempt was made physically to segregate popcorn which was purchased and popcorn which was grown by taxpayer. Taxpayer, in at least one of the taxable years involved, furnished his accountant who prepared his income tax returns with inventory and purchase figures based upon market price rather than cost. Taxpayer did not keep accurate inventory records and his books and records did not properly reflect his true income during the years 1942 to 1945 inclusive. (R. 250.)

At the beginning of the taxable period, taxpayer had approximately 1,800,000 pounds of popcorn stored in cribs on the family farm. This popcorn had been grown on the farm in 1941 or earlier years, or had been acquired under taxpayer's contracts with other farmers. Taxpayer also had some popcorn stored at his manufacturing plant and some stored on the farms of others. The popcorn which taxpayer had at the beginning of 1942 had cost approximately $31,352.[2] Tax-

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[2] This was one of the three controverted items appearing in the Commissioner's computation of taxpayer's assets at the starting point. On his income tax return for 1942 taxpayer had reported a beginning inventory of $9,221.46, and this was the figure credited to the taxpayer in the Commissioner's computation. (R. 8, 253.) In raising this figure to $31,352, the Tax Court pointed out that on a financial statement rendered as of April, 1942, taxpayer had estimated the cost of his "salable merchandise" at $31,352. The court found that this figure (which would give an average *cost* of about $1.74 per hundred pounds for 1,800,000 pounds of which petitioner had raised about 600,000 pounds him-

payer spent nearly all the cash he had or could borrow purchasing popcorn. He did not have in excess of $933[3] in cash at the end of that year. (R. 249.) Between January 1, 1935 and December 3, 1941, taxpayer was continuously borrowing sums up to $4,000 from the Pendleton Banking Company. He did not file an income tax return prior to 1942 when he filed a nontaxable return for 1941. There is no record of taxpayer's mother or father ever filing an income tax return. Taxpayer's father died on February 14, 1934, leaving personal property appraised at $10,653.03. (R. 249-250.)

Taxpayer's liabilities on January 1, 1942, exclusive of the amount borrowed from his mother, totalled $11,000. His living expenses were $5,000, $7,000, $12,000 and $10,000 in 1942, 1943, 1944, and 1945, respectively. (R. 251.)

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self) could be reconciled with the average *price* for popcorn which was $2.08 per hundred pounds in 1941 and less in 1940. (R. 253-254.)

[3] This was another of the three contested items in the Commissioner's computation of taxpayer's assets at the starting point. (R. 254-255.) With respect to this item the Tax Court stated (R. 254):

> Petitioner testified that he had $150,000 in cash when he rendered the financial statement of June 12, 1941. We find this testimony wholly unbelievable. Prior to mentioning this cash hoard, which had allegedly been hidden in the well pit of the milkhouse since 1936, petitioner testified several times that he was unable to name any assets which had been omitted from the statement of June 12, 1941.

The third disputed item was furniture. The Tax Court accepted taxpayer's testimony that he had $1,344.55 in furniture prior to 1942. (R. 255.)

Taxpayer filed financial statements with the Anderson Banking Company of Anderson, Indiana, showing a net worth on the dates indicated as follows:

June 12, 1941	$64,466.49[4]
April 1, 1942	74,093.00
January 3, 1944	112,549.00
January 3, 1945	126,602.78
November 10, 1945	430,634.92

Taxpayer certified each of these statements to be a true and correct statement of his financial condition at the time. (R. 251.)

Taxpayer's 1943 income tax return was filed on April 15, 1944. His purported income tax return for 1944, which was signed by the accountant who prepared it but not by taxpayer, was filed on March 9, 1945. (R. 248.)

The Tax Court concluded that taxpayer's net worth during the period January 1, 1942 to December 31, 1945, increased $230,357.94 (R. 251), and that his reported, actual and unreported adjusted gross income for each of the taxable years was as follows (R. 252):

Year	Reported	Actual	Unreported
1942	$ 4,978.14	$ 19,213.53	$ 14,235.39
1943	8,604.22	54,807.65	46,203.43
1944	17,679.56	70,739.45	53,059.89
1945	26,594.96	135,728.86	109,133.90

[4] The Commissioner's computation of taxpayer's opening net worth had credited him with $60,431.75 on December 31, 1941. (R. 8.) This figure, as adjusted by the Tax Court (changing inventories from $9,221.46 to $31,352, adding $1,344.55 in furniture, and changing liabilities from $3,387.71 to $11,000), was increased to $76,294.55.

The Tax Court also concluded that at least part of the resulting deficiency in each year was due to fraud with intent to evade tax. (R. 252.)

The Court of Appeals in a unanimous opinion affirmed the decision of the Tax Court. (App. 3a-10a.)

ARGUMENT

The factual and legal issues presented to the Tax Court and the Court of Appeals received careful consideration and were correctly decided. There is no conflict or other reason for further review.

1. The major issue presented to the Tax Court and the Court of Appeals concerned the propriety of the Commissioner's use of the net worth method to determine the taxpayer's correct net income. The contention of the taxpayer in the Tax Court and in the Court of Appeals was that in the absence of a showing of the inadequacy of the taxpayer's books and records or in the absence of a showing that concealment of income or falsity of books exists, the net worth method may not be used. The Court of Appeals, however, correctly recognized, in accordance with the decision of this Court in *Holland* v. *United States,* 348 U.S. 121, that proof of unreported income by the net worth method itself casts doubt on the reliability of a taxpayer's books and records and no preliminary showing of unreliability or falsity need be made. This is also in accord with decisions in other Courts of Appeals. Cf. *Thomas* v. *Commissioner* 223 F. 2d 83 (C.A. 6th); *Canton* v. *United States,* 226 F. 2d 313 (C.A. 8th). Moreover, as the Tax Court pointed out (R. 253), the books and records of the taxpayer were inadequate and the Court of Appeals expressly stated

(App. 5a) that "this finding is well supported by the evidence."

2. The only questions raised by the taxpayer in the Court of Appeals and the Tax Court, apart from the propriety of using the net worth method, related to the determination of opening net worth, specifically items of cash on hand and inventory, and the finding that a part of the deficiency for each of the taxable years (1942 through 1945, inclusive) was due to fraud with intent to evade tax. However, concurrent findings of two lower courts on such factual matters are entitled to finality in the absence of exceptional circumstances. Cf. *Comstock* v. *Group of Investors*, 335 U.S. 211, 213-214; *Allen* v. *Trust Co.*, 326 U.S. 630, 636; *Tennessee Coal Co.* v. *Muscoda Local*, 321 U.S. 590, 605.

The Court of Appeals (App. 6a-7a) approved the Tax Court's finding (R. 249) that the taxpayer's cash on hand on January 1, 1942, the beginning of the first taxable year, was $933. This amount was taken from a certified financial statement submitted by Davis to a bank in June, 1941. (Ex. B, R. 63, 195.) In April, 1942, Davis, in a similar certified statement, claimed he had $1,500. (Ex. C, R. 66, 197.) The record further established a long history of borrowing (Ex. P, R. 129, 242); no prior history of filing income tax returns, except for 1941, when a nontaxable return was filed (R. 249); and no likely sources of gifts or inheritances (R. 250) with which to amass the cash hoard of $150,000 which petitioner later "remembered" (R. 103, 127).[5] Indeed, in view of the Tax Court's

[5] "On cross-examination, taxpayer was repeatedly asked to state any assets which he owned that were not listed on the

characterization of the taxpayer's testimony as "wholly unbelievable" (R. 254) and "patently false" (R. 255), the Court of Appeals aptly characterized the Tax Court's allowance of $933 for opening cash on hand as a "generous" one (App. 7a).

The factual determination that Davis had an inventory of over $31,000 on January 1, 1942, being substantially more than the $9,221.46 (R. 253) claimed by him on his income tax return for 1942, is supportable by the admissions of the taxpayer on his return and the other evidence of record. The Tax Court and the Court of Appeals were certainly not bound to accept the subsequent testimony of Davis, which the Tax Court characterized as "generally unreliable." (R. 254.) *Staudenmaier* v. *Johnson,* 117 F. 2d 397 (C.A. 7th); *Cohen* v. *Commissioner,* 148 F. 2d 336 (C.A. 2d).

The finding of fraud was amply supported. The fact of the large understatement of income of $222,632.61 over a period of four consecutive years in relation to the reporting of only $57,856.88 (R. 252), the fact that Davis was spending money in excess of that reported by him (R. 35, 77, 251), his recognition that his "business has grown considerably each year and my net worth has gone up each year" (R. 186), the certified net worth statements submitted to a bank showing

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financial statement and he could not recall any. After a luncheon recess taxpayer 'remembered' that he had a cash hoard of $150,000 which had been hidden on his farm since 1936." Opinion of the Court of Appeals, App. 7a.

increases of over $350,000 in a period only slightly longer than that involved herein, and the fact that Davis reported income of only $26,594.96 (R. 252) for the year 1945, after his accountant informed him (R. 243) that his income computed on a cash basis was almost $60,000 for the first ten months of 1945 and about $117,000 computed on an accrual basis (which Davis should have been using since he kept inventories, Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, Secs. 29.41-2 and 29.41-3(1)), when coupled with the fact that Davis attempted to fabricate a "patently false" and "wholly unbelievable" story (R. 254, 255), fully warrant the finding approved by the Court of Appeals, that a part of the deficiencies for each of the taxable years was due to fraud with intent to evade tax. The record amply demonstrates that the courts below[6] properly exercised their respective functions in passing on these factual issues.[7]

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[6] The Tax Court did not resolve all of the factual issues presented to it adversely to the taxpayer. Because of certain adjustments made by it the net income of the taxpayer as determined by the Commissioner was reduced about $20,000. (Cf. R. 7, 252.) The Commissioner did not seek review of these adverse determinations.

[7] In his petition, the taxpayer raises issues not previously brought to the attention of either of the courts below. While this in itself should preclude consideration being given to them by this Court (cf. *General Utilities* v. *Helvering*, 296 U.S. 200, 206), we submit that they are without merit and do not warrant the grant of the petition. The claim that the taxpayer was a farmer and the net worth method is not available in cases involving farmers (Pet. 2, 12-13) is wholly unsupported by the citation of any authority. There is no justification of a special exception from the net worth method for farmers. In any event,

(*Continued on page 11*)

the magnitude of popcorn sales as compared to farm expenses (R. 251) shows that during the tax years, the taxpayer was principally a manufacturer and seller of popcorn and not a farmer. Moreover, the claim that inventories should not be used in computing the net worth of farmers (Pet. 12) is baseless. Although farmers may report income without using inventories, they may, on the other hand, elect to use inventories, as the taxpayer did on his tax returns. (See R. 253.) Treasury Regulations 111, Section 29.22(a)-7. And the taxpayer's election to use inventories required him to be on the accrual basis of accounting. Treasury Regulations 111, Sections 29.41-2 and 29.41-3. The contention (Pet. 4) that the taxpayer's liability to his mother should have been taken into account is shown to be without merit by the Tax Court's recognition that this liability at the beginning of the period was offset by a corresponding liability at the end of the period. (R. 255.)

The allocation of the unreported income for the four-year period to each of the taxable years by using a ratio based upon sales, now contested by taxpayer, is certainly a reasonable one. The inadequacy of taxpayer's books and records, a situation of the taxpayer's making, occasioned the use of this method and, in the circumstances present, the taxpayer at this point has no standing to complain. Cf. *Cohan* v. *Commissioner*, 39 F. 2d 540, 544 (C.A. 2d); *Lias* v. *Commissioner*, 235 F. 2d 879 (C.A. 4th), certiorari denied April 22, 1957; *Mikelberg* v. *Commissioner*, 23 T.C. 342, 350, affirmed *per curiam*, 234 F. 2d 34 (C.A. 3d), certiorari denied, 352 U.S. 968; *Archer* v. *Commissioner*, 227 F. 2d 270, 273-274 (C.A. 5th); *Estate of Bartlett* v. *Commissioner*, 22 T.C. 1228, 1232. It may also be noted that the burden of proving error in the Commissioner's determination was upon the taxpayer and no effort was made by him in the Tax Court to show that the determination was incorrect for this reason.

The failure of the taxpayer to introduce any evidence that his failure to file a valid return for the year 1944 was due to reasonable cause rather than wilful neglect within the meaning of Section 291 of the Internal Revenue Code of 1939 (R. 256-257), an issue on which he also had the burden of proof (cf. *Coates* v. *Commissioner*, 234 F. 2d 459 (C.A. 8th); *Sanders* v. *Commissioner*, 225 F. 2d 629, 637 (C.A. 10th); *Lee* v. *Commissioner*, 227 F. 2d 181, 184 (C.A. 5th)), establishes the correctness of the Tax Court's decision on this issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MAY 1957.

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